



MACROECONOMIC IMPACT ON STOCK MARKET PERFORMANCE EVIDENCE FROM COLOMBO STOCK EXCHANGE

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Abstract

At the end of a Civil war which has lasted over three decades in Sri Lanka, Colombo Stock Exchange has started to peak and became one of the most promising and best performing stock markets in Asia. Therefore, it would be interesting for the potential investors as well as the policy makers to observe how this small equity market has reacted to the macroeconomic conditions and to what extent one could predict the performance of Colombo Stock Exchange (CSE) based on the macroeconomic conditions.

In this study it was deployed a series of econometric tests to identify the nature of both long and short term relationships between four selected macroeconomic variables and the performance of CSE using monthly data spanning for 24 years (1985 Jan.-2009 Apr.). Four macroeconomic variables were represented by Colombo Consumers' Price Index, Three Month Treasury Bill Rate, Exchange Rate and M1 Money Supply. CSE's performance is represented by the All Share Price Index.

Augmented Dickey-Fuller and Phillips-Perron unit root tests were employed to determine the stationarity of the time-series variables and to identify their order of integration. Testing of relationships between the variables were done through well accepted methodology of Johansen's (1991) Multivariate Cointegration and Vector Error Correction Modelling (VECM). Finally, Variance Decomposition and Impulse Response Functions were deployed to identify the dynamic linkages between the variables in the short run.

Cointegration and VECM approach has found evidence to suggest the existence of long term equilibrium relationship between the macroeconomic variables and the Colombo Stock Exchange Performance. Money Supply and Treasury Bill rate were found to have significantly strong positive and negative influence respectively, on the performance of CSE, while Colombo Consumers' Price Index has a weak yet statistically significant positive influence. Exchange Rate does not seem to exert any influence on the performance of CSE at all.



Keywords: *Colombo Stock Exchange, Stock Market Performance, Macroeconomic impact, Unit roots, Cointegration, VECM, Variance Decomposition, Impulse Response Functions, Causality*